CAPITAL MARKETS ECONOMICS

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Special Report: Is The Early Fed Taper Back On?

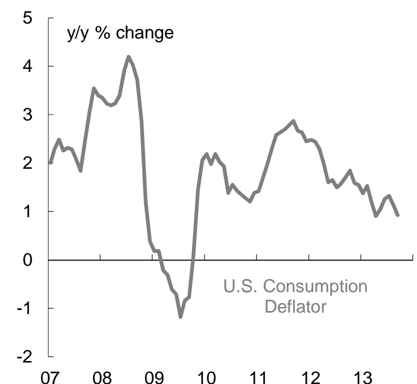
- **We do not think markets should interpret recent data strength as a sign of imminent Fed tapering.**

Markets have been encouraged by the recent flow of US data and have brought forward the point at which they believe the Federal Reserve will taper asset purchases to a date earlier than our March 2014 or later view. This has been manifest through the Treasury curve steepening and a stronger USD in the wake of recent data. There are several points of caution to be noted, however, and they lead us to continue to expect tapering in March or later.

Inflation Plumbing The Depths Of The Crisis Era

The Fed's preferred measure of inflation — the price deflator for total personal consumer expenditures — came in at +0.9% y/y in September. We feel that markets are underestimating the importance of this observation to the Fed. That is tied with April for the softest inflation reading since October 2009 when the US economy was just beginning to emerge from recession (chart 1). A global disinflationary push that is getting most advanced western nations except the UK caught up in the trend is likely to keep Fed policy highly stimulative and unchanged for longer than markets anticipate at the moment. Furthermore, market-based measures of inflation expectations such as the Fed's preferred five-year forward breakeven, or TIPS breakeven rates remain well behaved. It is possible that while the jobs picture has performed somewhat better than expected, the Fed may strengthen references to low inflation and thus shift the debate at the margin more toward this part of its dual mandate.

Chart 1 **Falling Inflation A Growing Fed Challenge**

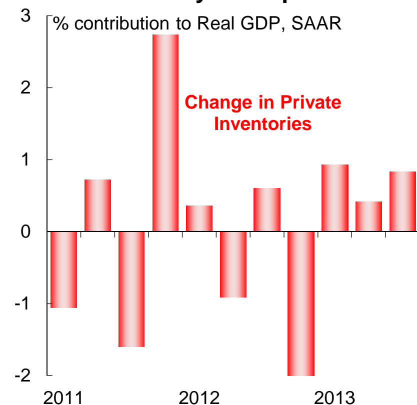


Source: BEA, Scotiabank Economics.

Q3 GDP Upside Surprise Could Give Way To Q4 Weakness

We think Q4 GDP growth could return to a subdued low-one-handled pace for two reasons. One is that the solid U.S. Q3 GDP number (+2.8% q/q) was significantly attributable to a +0.8% contribution from $86 billion worth of inventory restocking which was toward the upper end of recent experiences (chart 2). We think it was an undesired short-term inventory build and that it is unlikely to repeat in Q4. Indeed, inventories could turn into a drag effect on growth.

Chart 2 **Inventory Addition Unlikely To Repeat**



Source: BEA, Scotiabank Economics.

Also note that this number covered Q3 — before the partial government shutdown in October. During the Clinton era shutdown, a 3.5% q/q drop in government spending in 1995Q4 knocked 0.8 points off of headline growth (chart 3). We think the effect this time might be roughly comparable. When combined with the unlikely extension of an inventory build, both effects could return Q4 GDP growth to a low one-handled pace in our view. Q4 GDP figures will be released on January 30th 2014 — the day after the January 29th FOMC statement.

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Delayed Jobs Shock?

Although the October non-farm payrolls number smashed expectations, coming in at 204k, above all of the estimates in consensus, we would hesitate getting too excited about the number. First, back during the Clinton shutdowns that began in November and ended in January in 1995-96, the job shocker emerged in January — which might suggest that the focus now shifts to the November payrolls print (chart 4). Second, the six month trend in job creation is 174k, which is below what is thought to be the Fed' s comfort zone of around 200k/month for a prolonged period. Trend payroll growth under 200k/month is likely inadequate for the Fed particularly as the labour force participation rate continues to plummet for a variety of structural and cyclical reasons that on balance point to greater slack in job markets than evident via observing just the unemployment rate.

Shutdown Round 2?

The fiscal policy-making calendar remains a major concern. While things might be quiet for the moment, there is a December 13th due date for congress to come up with a budget on its own. We're not optimistic and expect a more protracted period of uncertainty. Further, the government is only authorized to continue spending money until January 15th, at which point another government shutdown will occur absent funding authorization. Third, the debt ceiling must be raised again by February 7th or a period thereafter upon considering renewed emergency measures pursued by the US Treasury. In short, the same fiscal policy risks that concerned the Fed in September are looming in early 2014. Chairman Bernanke has made it abundantly clear that the Fed will be wary of adding monetary policy instability to fiscal policy uncertainty including at his semi-annual testimony to Congress in July.

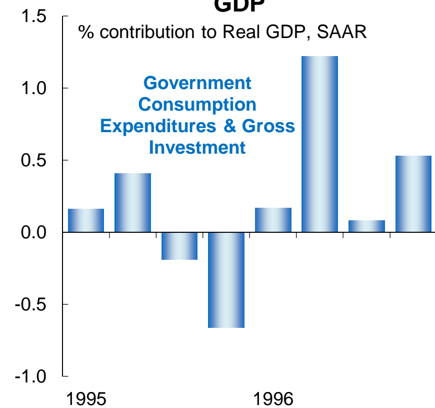
Housing Faces Continued Lagged Rate Sensitivity

We expect housing data to get worse before stabilizing and in the wake of the rate shock that has been imposed upon housing since May. Mortgage purchase applications are now down 20.7% in seasonally adjusted but non-annualized terms since the peak in early May. Purchase applications are now cruising the depths of the readings posted over the 2010-onward period (see chart 5). This works against hopes for a sustained housing recovery as the lagged effects will continue to work through lower readings for pending home sales, new home sales, housing starts, and lastly resales. We'll watch for renewed upward pressure upon mortgage borrowing costs going forward in the wake of the recent Treasury curve steepening. That could prompt the Fed to reintroduce the warning in the September statement that " the tightening of financial conditions observed in recent months, if sustained, could slow the pace of improvement in the economy and labor market."

Bubble Fears

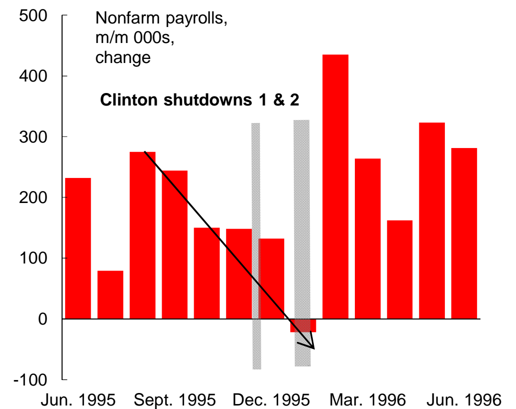
We're fully aware of the evidence of froth in some markets including CLOs (Collateralized Loan Obligations) and high yield. We are not, however, convinced that the broad financial and real asset markets lie in bubble territory and believe that the majority of the FOMC shares our belief. Witness chart 6 for instance that portrays a sustained rates sell-off

Chart 3 Clinton-Era Government Shutdown Temporarily Hit GDP



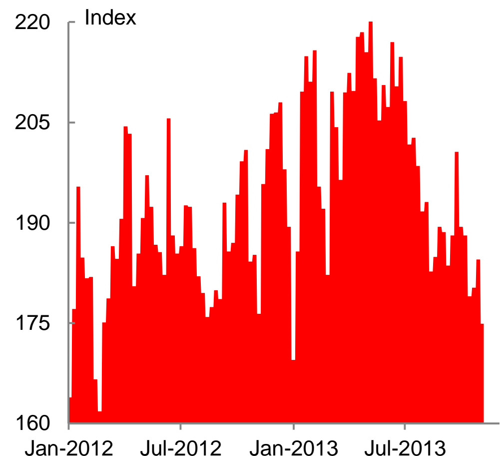
Source: BEA, Scotiabank Economics.

Chart 4 Jobs Quickly Deteriorated During The Clinton Shutdowns



Source: BLS, Scotiabank Economics.

Chart 5 U.S. Mortgage Purchase Applications



Source: Bloomberg, Scotiabank Economics

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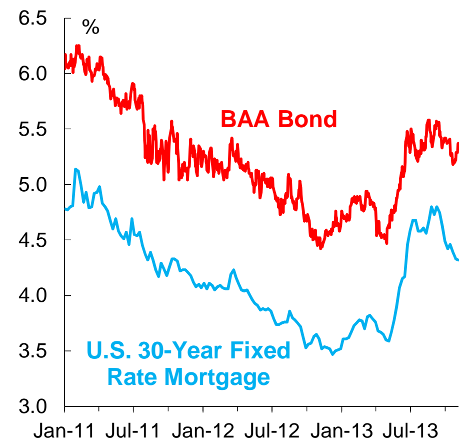
as opposed to returning to the yield depths seen when Chairman Bernanke delivered his testimony to the Joint Economic Committee in May. Further, we continue to discount simplistic portrayals of equity over-valuation that only point to index levels and percentage gains. Our seven relative valuation metrics for US equities continue to yield one of two conclusions — neither of which supports the bubble camp. Either stocks are cheap if valuations are compared to the 1990s-onward period, or fair value if compared to prior to the 1990s. We've always maintained that the pre-1990s period is likely the more appropriate comparison.

Chart 6 **Fewer Reach-For-Yield Worries**



Source: MBA, Moody's Investors Service, Scotiabank Economics.

Delaying The Inevitable

The path toward tapering may be longer than markets are currently fearing, and, with our March or later call, we continue to believe the inevitability is measured in months rather than weeks. There is clearly the risk of tapering in December or January, but also the risk of tapering later than we project. Our base case is that as the economy gradually gathers momentum next year, the Fed should find a more constructive environment within which to reduce asset purchases. We are also erring on the side of fiscal peace after the early New Year deadlines until at least after the Congressional mid-term elections next November in order to give some distance to the rancor in front of voters. Reduced marketable debt issuance through improvements in US budget deficits will also be conducive to reduced asset purchases. Continued monitoring of the risk of market dysfunction stemming from a rising share of Fed ownership of Treasuries and MBS will be required, and we think the limit on Fed ownership will be breached if the pace of asset purchases remains unchanged for much longer than our projected timeline. In sum, we think tapering has to happen at some point. Just not yet — even if we've had a few good data prints in the past week.